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Equality in the Eye of the Beholder—Classification of Claims and Interests in Chapter 11 Reorganizations

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From its beginnings as a colonial alternative to the English debtors' prisons, American bankruptcy law has been built on the twin foundations of the discharge for the debtor and the equality of treatment for the debtor's creditors.[1] These themes repeat throughout the bankruptcy law,[2] both in the statutory provisions promulgated by Congress and in the case law interpreting the statutes.

The reasons for these principles are obvious. The discharge encourages risk taking by affording the deserving debtor a fresh start in the event of failure, and equality of treatment of creditors promotes a fair and orderly liquidation of the debtor's assets in the event of insolvency. As Mr. Justice Black noted over thirty-five years ago, "Historically one of the prime purposes of the bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets; to protect the creditors from one another."[3]

Despite its role as a touchstone of bankruptcy law, equality of treatment of creditors remains an elusive concept. Nowhere is it more elusive than in reorganization cases. Unlike liquidation cases, which concern contests for shares in a fixed pool of assets, reorganization cases are contests for shares in an ongoing enterprise. The value of the debtor's assets becomes the starting point rather than the ending of the contest, and the future value of the assets or the earnings of the debtor may be as important as their present worth.

This inherent difference between liquidation and reorganization cases creates a dynamic tension between the principles of equality and the process of rehabilitation. Creditors of a debtor in reorganization will have different needs and different relations to the debtor that affect the reorganization. For example, some creditors will need cash immediately while others would prefer to wait for a larger dividend later; some creditors will be able to profit from future sales to a reorganized debtor while others will have no reason for further

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1. *See generally* P. COLEMAN, DEBTORS AND CREDITORS IN AMERICA—INSOLVENCY, IMPRISONMENT FOR DEBT AND BANKRUPTCY 1607–1900 (1974).

2. *See* Coogan, *Confirmation of a Plan Under Chapter 11*, 32 CASE W. RES. L. REV. 301 (1982).

3. Young v. Higbee Co., 324 U.S. 204, 210 (1945).

dealings with the debtor. In addition, the debtor or a creditor proposing a plan of reorganization may wish to divide creditors to promote the plan. Since a plan must be accepted by at least one class of affected creditors or interest holders,[4] the division of creditors into classes is critical, and the temptation to gerrymander creditors to assure acceptance is often irresistible.

In light of this dynamic tension between principles and politics, it is surprising that so little law or comment exists on the question of classification of claims and interests.[5] Classification of claims and interests within the corporate reorganization context is more than a determination of the similarity or difference in the nature of claims or interests. As Peter Coogan has noted, it is a "strategically important task," bound up with the ultimate goal of increasing the chances of obtaining class acceptances of the reorganization plan.[6]

Nonetheless, the present statute[7] fails to provide clear standards to guide the debtor in this task. The legislative history to the section on classification advises that debtors must forge their way through case law existing at the time the Bankruptcy Code was drafted to determine the appropriate criteria for the division of creditors into classes.[8] Unfortunately for the debtor, "few immutable principles"[9] exist that may be extracted with any consistency from that case law. Under this formula one can only study classification problems resolved under the prior Bankruptcy Act,[10] read with suspicion the recently decided chapter 13 cases under the current Code, and venture a guess whether and to what extent these cases will be applicable to chapter 11 classification problems.

The question addressed by this Article concerns the criteria used for classifying claims and interests within the context of corporate reorganization. More specifically, it addresses the appropriate criteria for the division of claims or interests into separate classes, and conversely, the appropriate criteria for including a group of claims or interests in the same class.

To explore this question, a close reading of the relevant Bankruptcy Code sections is imperative, as is a consideration of the prior Act sections and the case law interpreting those sections. Beyond this analysis, an overview of changes in bankruptcy law as a result of the enactment of the Code that have a bearing on the classification issue is necessary. Finally, a review of recent chapter 13 classification cases will afford a preview of emerging principles and problems under chapter 11.

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4. Bankruptcy Act of 1978, 11 U.S.C. § 1129(a)(10) (Supp. IV 1980).

5. *See* Vihon, *Classification of Unsecured Claims: Squaring a Circle?*, 55 AM. BANKR. L.J. 143 (1980).

6. Coogan, *Confirmation of a Plan Under Chapter 11*, 32 CASE W. RES. L. REV. 301, 329 (1982).

7. Bankruptcy Act of 1978, 11 U.S.C. §§ 1–151326 (Supp. IV 1980).

8. H.R. REP. NO. 595, 95th Cong., 1st Sess. 406 (1977); S. REP. NO. 989, 95th Cong., 2d Sess. 118, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5904.

9. 6 COLLIER ON BANKRUPTCY ¶ 9.10, at 1595 (J. Moore 14th ed. 1978).

10. Bankruptcy Act of 1938, 11 U.S.C. §§ 1–1103 (1976) (amended 1978).

I. STATUTORY CONSIDERATIONS

To begin, section 1122 of the Bankruptcy Code specifically provides:

(a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.
(b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.[11]

The first distinction subsection (a) draws is between claims and interests. A plan proponent may place "substantially similar" claims in the same class and "substantially similar" interests in the same class, but claims and interests are inherently different and must be classified separately. "Claim" describes a creditor's rights against the debtor; "interest" involves proprietary rights in the debtor.[12] The second principle enunciated in subsection (a) is that while claims or interests within a class must be "substantially similar" to one another, no concomitant requirement exists that all claims or interests which are "substantially similar" must be placed in the same class.[13]

Aside from these basics, the cryptic language of subsection (a) provides few clues to the criteria to be used in the classification process, and the accompanying legislative history has done little more than further muddy the less than clear waters. The legislative history states in relevant part:

> This section codifies current case law surrounding the classification of claims and equity securities. It requires classification based on the nature of the claims or interests classified, and permits inclusion of claims or interests in a particular class only if the claim or interest being included is substantially similar to other claims or interests of the class.[14]

Before turning to the "current case law" to which the legislative history refers, a brief comparison with sections of the prior Act will prove helpful.

The provisions of the Act in each particular chapter were substantially similar to one another. Section 197 of chapter X was derived from former section 77B(c)(6), which provided that "the judge . . . shall determine . . . for the purposes of the plan and its acceptance, the division of creditors and stockholders into classes according to the nature of their respective claims and interests."[15]

Section 197 changed little from section 77B; the word "stock" was substituted for the word "interests." However, section 197 was effectively

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11. 11 U.S.C. § 1122 (Supp. IV 1980).
12. Standard Gas & Elec. Co. v. Taylor (*In re* Deep Rock Oil Corp.), 113 F.2d 266 (10th Cir.), *cert. denied*, 311 U.S. 699 (1940).
13. 5 COLLIER ON BANKRUPTCY ¶ 1122.03[1] (L. King 15th ed. 1982).
14. S. REP. NO. 989, 95th Cong., 2d Sess. 118, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5904.
15. Act of June 7, 1934, ch. 424, 48 Stat. 911, 916 (amended 1938).

superseded by Bankruptcy Rule 10-302, which provides as follows: "(a) Classification of Claims. For the purpose of the plan and its acceptance, the court may fix, after hearing on such notice as it may direct, the division of creditors and stockholders into classes according to the nature of their respective claims and stock."[16]

Although rule 10-302 changed very little of section 197, the mandatory "shall" that appeared in section 197 was softened to the permissive "may," and a provision for a hearing on the matter accompanied the judge's classification determination.

Sections 351 of chapter XI[17] and 452 of chapter XII[18] paralleled one another, as well as rule 10-302, with certain variations. Section 351 omitted the "nature of their respective claims" language found in chapters X and XII, and both sections failed to differentiate between claims and interests, as does chapter X.[19] However, the language found in the permissive provisions of section 357 was more explicit. It provided: "An arrangement within the meaning of this chapter may include (1) provisions for treatment of unsecured debts on a parity one with the other, or for the division of such debts into classes and the treatment thereof in different ways or upon different terms; . . . ."[20]

Without more, this brief comparison between the applicable statutes reveals that section 1122(a) of the Code brought forward the distinction between claims and interests from section 197 and rule 10-302 and took away the court's independent power to designate classes. That power is now the exclusive prerogative of the debtor and creditors. Since the statutory language has been virtually replicated from chapter to chapter, the issue of classification may be considered without particular regard for the chapter under which the petition was filed and without regard for the difference between the chapters.

Therefore, this analysis will commence with a review of a representative sample of cases holding the separation of certain claims as unwarranted and of the courts' concomitant reasons for combining claims in a single class.

II. SINGULAR CLASSIFICATIONS

In one of the early railroad reorganization cases, *J.P. Morgan & Co. v. Missouri Pacific Railroad*,[21] the court followed the letter of the statute when it classified three similar claims in the same class. The statute in effect at the

16. FED. R. BANKR. P. 10-302.
17. 11 U.S.C. § 751 (1976) (repealed 1978).
18. 11 U.S.C. § 852 (1976) (repealed 1978).
19. This distinction was omitted because a chapter XI plan could deal only with unsecured claims and because chapter XII relief was restricted to noncorporate debtors. *See* FED. R. BANKR. P. 12-3 advisory committee note.
20. 11 U.S.C. § 757(1) (1976) (repealed 1978).
21. 85 F.2d 351 (8th Cir.), *cert. denied*, 299 U.S. 604 (1936).

time prohibited separate classification "unless there be substantial differences in priorities, claims, or interests."[22]

The appellant, J.P. Morgan & Company, held short-term promissory notes of the debtor, which were secured by a combination of the railroad's first and refunding five percent gold bonds and shares of gold stock. The other two claimants grouped in the same class with Morgan both held similar short-term promissory notes secured by the same type of collateral. One claimant's notes were said to be secured by "shares of stock in sundry corporations and notes and bonds other than Missouri Pacific notes and bonds and other collaterals."[23]

Morgan attacked the classification on several grounds, including the differences between its claims against the railroad and those of the other two creditors. It also argued that classification ought to be made according to the interests of the claimant rather than according to the nature of the claims.[24] The court, however, failed to yield to Morgan's complaints of differences and its interpretation of the word "interests."[25] *Missouri Pacific Railroad* has been cited repeatedly[26] for its interpretation of the phrase "nature of their respective claims and stock" to deny classification based upon the nature of the claimant or stockholder or his interest in the reorganization in the sense of the claimant's bias, leanings, or relationship to the debtor.

While this case may not be persuasive authority for classification today, since separate classes were only sanctioned when "substantial" differences existed, it did establish that classification is based on the nature of the claim and not on the bias of the claimant.

This distinction between the nature of the claim and the identity or nature of the claimant was confirmed recently in the Bankruptcy Code case of *In re Martin's Point Ltd.*[27] In this case the debtor created a class of second-priority secured creditors consisting of three creditors with equal-priority security interests in the sole asset of the debtor, the Martin's Point Plantation. These interests arose when the three prior joint-tenancy owners of the plantation sold the property to the debtors and received separate purchase-money promissory notes secured by a single second mortgage.[28]

One of these three creditors, Dawson, objected to the classification scheme and voted to reject the plan. Since the other two class members amounted to more than half of the creditors of the class and their claims collectively amounted to more than two-thirds of the claims, the class as a

22. 11 U.S.C. § 205(c)(7) (1976) (repealed 1978).
23. 85 F.2d 351, 352 (8th Cir. 1936).
24. *Id.*
25. *Id.*
26. *See, e.g.*, Freeman v. Mulcahy, 250 F.2d 463, 477 (1st Cir. 1957); St. Louis Union Trust Co. v. Champion Shoe Mach. Co., 109 F.2d 313, 316 (8th Cir. 1940).
27. 12 Bankr. 721 (Bankr. N.D. Ga. 1981).
28. *Id.* at 724.

whole accepted the plan under section 1126.[29] Under the plan the class received the debtor's interest in the plantation along with 13,000 shares of Federal Land Bank stock in satisfaction of the indebtedness. Furthermore, Dawson was given a choice of exchanging his interest in the plantation for either $160,000 cash or $190,000 in the form of a promissory note.[30] In effect, the other class members offered to purchase Dawson's interest in the plantation at his election.

Despite these options, Dawson objected to the classification of his claim in the same class on the grounds that the other class members were also equity security holders and, therefore, the holders of claims that were not "substantially similar" to his claim. Dawson further argued that his claim differed from the other two claims in his ability to seek a deficiency judgment following a foreclosure sale.[31]

The court did not accept the deficiency judgment argument and noted that the other claimants held only minimal limited partnership interests in the debtor.[32] More importantly, it held that even if Dawson's rights to a deficiency differed, and even if the other claimants held significant partnership interests, their secured claims were substantially similar and properly included in the same class: "It is the 'nature' of their claims being classified together that is significant, not the nature of other claims or interests a creditor may have. . . . The code provides that in order for creditors to be classified together, their interest need be only substantially similar and not identical."[33]

The latter principle is derived directly from *Seidel v. Palisades-on-the-Desplaines (In re Palisades-on-the-Desplaines)*,[34] a leading section 77B case decided by the Seventh Circuit. The facts of *Palisades-on-the-Desplaines*, though somewhat complicated, may be summarized as follows: The debtor was a common-law trust, the beneficial interests or ownership in which were evidenced by certificates. The principal assets of the trust consisted of twenty-two parcels of land, nineteen of which were encumbered by separate purchase-money mortgages secured by separate trust deeds. One of these nineteen parcels was purchased from the appellant, who held one of the purchase-money mortgages secured by a separate trust deed.[35]

Three of the debtor's creditors filed an involuntary petition in bankruptcy under section 77B of the Bankruptcy Act, and nine months later the debtor filed its proposed plan of reorganization. The court in its order of classification of claims placed appellant's claim in Class A with that of the other eighteen mortgagees who had separate and distinct collateral. As a result, the appellant objected to the classification scheme and argued that the court

29. 11 U.S.C. § 1126 (Supp. IV 1980).
30. 12 Bankr. 721, 723–24 (Bankr. N.D. Ga. 1981).
31. *Id.* at 725–26.
32. *Id.* at 727–29.
33. *Id.* at 727.
34. 89 F.2d 214 (7th Cir. 1937).
35. *Id.* at 215.

should have placed appellant in a separate class apart from any class containing the holders of mortgages that were a first lien on other separate tracts of land owned by the debtor.[36]

In addressing this question and citing the relevant statutory section,[37] the Seventh Circuit concluded that the court had "broad latitude in its classification of debtors [*sic*]."[38] In its words, "[S]uch classification, of course, should not do substantial violence to any claimant's interest, nor should it uselessly increase the number of classifications unless there be substantial differences in the nature of the claims."[39]

In determining that the appellant's claim was not entitled to separate classification, the court made an exception to the interpretation of the statute as provided in a contemporary treatise on corporate reorganization. In the words of the treatise:

> All creditors of equal rank with claims against the same property should be placed in the same class. This is natural, logical, and a simple basis of division.
>
> Conversely, creditors of different ranks, or creditors of the same rank but with claims against different properties, should be placed in different classes. The owners of a mortgage which is a first lien on certain property should be in a class other than one containing the owners of a mortgage which is a second lien on the same property. So, also, the holders of a mortgage which is a first lien on certain property should be in a class other than the one containing the holders of a mortgage which is a first lien on other property.[40]

In making its exception to this rule, the court compared the similarities of the claims as well as their differences:

> All "Class A" claims are the same in the following respects: They are all secured by first mortgages or trust deeds on real estate; the indebtedness in each is evidenced by a principal note or notes; the properties are all located in the same locality; they form a part of a single project; they were purchased at approximately the same time; the obligations mature at about the same time; and the remedy afforded each holder for realization on his mortgage is the same. They differ in the following respects: The trust deeds are liens on different and distinct parcels of land; the values of the individual properties are different; the trust deeds secure different amounts and are due at varying times; and the ratio of encumbrance to purchase price is different in each case.[41]

After comparing the claims the court determined that the appellant was not harmed by the classification. This may have been a major factor in the court's refusal to create separate classes for each security instrument secured by separate pieces of property. Even though the appellant's property was more valuable than that of any of the other Class A claimants, the appellant would receive almost three times his own valuation of the security if the plan

36. *Id.* at 215–16.
37. Act of June 7, 1934, ch. 424, § 1, 48 Stat. 911, 912 (amended 1938).
38. 89 F.2d 214, 217 (7th Cir. 1937).
39. *Id.*
40. 2 J. GERDES, CORPORATE REORGANIZATIONS § 1045 (1936).
41. 89 F.2d 214, 217 (7th Cir. 1937).

were consummated successfully. If the plan were not consummated, the appellant still would receive the security without the necessity of foreclosure. While the arrangement regarding each mortgage holder was the same, the ultimate distributions differed. The reorganization plan provided that deeds were to be executed to the persons holding mortgages in consideration for the cancellation of those mortgages. Simultaneously, the recipients of the deeds would individually execute contracts with another company under the terms of which this company would purchase the real property from the then owners at prices equal to seventy percent of the amount of the principal and interest due at the time of confirmation of the plan.[42]

The court did not feel that this factor or any other differences cited were sufficient to warrant separate classifications, despite the generally accepted rules that real property is unique and that liens on different properties require separate classification. In the court's words, classification was effected "according to the nature, or pertinent characteristics, of the respective claims and interests."[43]

Thus, just as a definable species began to emerge, a mutant developed. It is an exception to the general belief that all separate parcels of real estate are inherently unique. It is also an acknowledged exception to the general rule that creditors of the same rank but with claims against different properties should be placed in different classes. New strains of this mutant already have appeared in chapter 13 cases[44] and may yet appear in chapter 11 reorganizations.

As a result of this general rule, most classification problems center around the further division of unsecured claims or the denial of further classification. As *Collier on Bankruptcy* succinctly notes: "The fact that the [unsecured] claims may take various forms—as, for example, notes, accounts, written contracts, torts or the like—will not ordinarily compel separate classification since an unsecured indebtedness or liability is the common denominator of all."[45]

One example of court denial of further classification is the oft-cited case of *Scherk v. Newton (In re Rocky Mountain Fuel Co.)*.[46] In this case a debtor experienced financial difficulties for many years and, in an attempt to bail itself out, proposed a voluntary plan for a reduction in interest rates on its bonds. Ninety-three percent of the outstanding bondholders assented to the plan; however, some of the nonassenting bondholders instituted actions against the debtor to recover the principal of their bonds and the accrued interest. As a result, the debtor was forced to file a petition for reorganization under chapter X.[47]

42. *Id.* at 217–18.
43. *Id.* at 218.
44. *See infra* text accompanying notes 192–208.
45. 6 COLLIER ON BANKRUPTCY ¶ 9.13(1) (J. Moore 14th ed. 1978).
46. 152 F.2d 747 (10th Cir. 1945).
47. *Id.* at 748–49.

The court of appeals affirmed the district court's classification of claims, which placed both assenting and nonassenting bondholders in the same class. This decision was based not only on the equities of the situation but also on provisions in the trust indenture that provided for parity of treatment between holders of all the bonds and coupons, despite the consent by some to a reduction in interest and an extension of maturity of the principal.[48]

In one of the classic statements on classification the court acknowledged that "[c]lassification is simply a method of recognizing difference in rights of creditors which calls for difference in treatment."[49]

Another example of court denial of separate classification is *In re Hudson-Ross, Inc.*,[50] in which the court grappled with this problem while reviewing the referee's order approving the debtor's chapter XI plan of arrangement. Under the proposed plan all unsecured merchandise creditors were to be paid in full except for ten major trade creditors. These ten creditors were placed in a separate class slated to receive thirty-five percent of their May 1, 1958, claims due and unpaid, as well as payment in full for indebtedness subsequently incurred. This difference in treatment and separate classification arose from an earlier extension agreement entered into between the debtor and the ten creditors to liquidate the past indebtedness owing to these creditors.[51]

Since nothing in the extension agreement discharged the debtor's obligation to those creditors or evidenced any intention on the creditors' part to be subordinated to other creditors, the court determined that no justification existed for the separation of the creditors into two classes. In discussing this problem the court opined:

> The Bankruptcy Act sanctions a division of creditors into classes and a treatment thereof in different ways or upon different terms. Such classification, however, must be necessary and proper and made on a reasonable basis in order that the arrangement be for the best interests of all creditors. Ordinarily, a creditor is not entitled to better treatment merely because he holds a small claim rather than a large one.[52]

The court, therefore, held that the separation of unsecured creditors into two separate classes was not made on any reasonable basis and that it was arbitrary and discriminatory. The court set aside the referee's order confirming the plan of arrangement.[53]

Cleaving to this point of view, the court in *In re Los Angeles Land & Investments, Ltd.*[54] issued one of the classic statements defining the nature of a claim under the Bankruptcy Act:

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48. *Id.* at 749–51.
49. *Id.* at 750.
50. 175 F. Supp. 111 (N.D. Ill. 1959).
51. *Id.* at 112.
52. *Id.*
53. *Id.* at 114–15.
54. 282 F. Supp. 448 (D. Hawaii 1968), *aff'd*, 447 F.2d 1366 (9th Cir. 1971).

> The courts recognize that the word "nature" is used in no technical sense in law but is used in its ordinary common vernacular, wherein it means kind, sort, species or character. Where the differences are in the rates of interest, in the amounts, in the dates of maturity, in names of payees, the manner in which the claim arose and such other minor details, they cannot affect the "nature," i.e., the kind of claim, otherwise a separate class would have to be provided for nearly every type of situation which would be an unthinkable calamity when the object and aim of the statute is regarded.[55]

The court went on to opine that only under special circumstances may unsecured creditors be divided into separate classes. On the basis of these principles the court accepted the general unsecured creditor classification recommended by the trustee, which included "holders of promissory notes which are unsecured, open account creditors for services rendered or materials delivered, and holders of contracts for sale of real estate and/or investment contracts to the extent of payment made plus interest thereon prior to the date of filing of the petition."[56]

It accepted this singular classification of a variety of unsecured creditors because:

> These categories of unsecured claims are of the same kind, sort or character, the "nature" varies in only minor details concerning primarily the manner in which they arose. The class in its entirety has the basic "nature" of all of them being the holder of an unsecured indebtedness or liability which factor is "the common denominator of all." There does not appear to be any justification to fragment the classification and uselessly increase their number where there is no substantial differentiation in the "nature" of their claims to justify such a decision.[57]

With this statement the Ninth Circuit returned to the dynamic tension between principles of equality and the politics of the reorganization process by introducing one further consideration into the classification dilemma: claims classification from the practical standpoint. For example, under general classification principles one hundred pieces of equipment subject to separate first liens theoretically should be classified separately. However, the mechanical problems of this separation may prove unwieldy. For this reason the combination of substantially different claims may be advisable when separation would greatly increase the number of classes. When separation of claims has not threatened a drastic increase in the number of classes and sufficient justification has existed, many courts have been willing to allow separate classification, as the next set of cases demonstrates.

III. Separate Classifications

As previously noted, in most situations separate classifications are created when the collateral securing each claim differs. This follows from the general rule that the legal character or effect of a claim relative to the debtor's

55. *Id.* at 454.
56. *Id.*
57. *Id.*

assets determines the classification scheme.[58] Bound up with this determination, however, are subordination considerations, voting manipulation concerns, and different treatment to be accorded creditors who are *in pari passu*.[59] As is always the case in bankruptcy law, the courts' holdings inevitably are colored by the facts of each case, which warns one that a principle enunciated in one case may not necessarily be relied upon in another fact situation.

A. *Subordination Considerations: Equitable and Otherwise*

While classification in early decisions under the Chandler Act[60] proceeded on the basis of the absolute priority rule announced in *Northern Pacific Railway v. Boyd*,[61] this rule always was subject to the doctrine that the reorganization court may subordinate, postpone, or classify separately for different treatment particular claims of a certain group on the basis of equitable considerations invoked by the particular facts.[62] Thus, whether equitable subordination has formally occurred, equitable considerations frequently have played an important part in the classification process, as the following cases demonstrate.

A prime example of affording preferred status to a group of creditors based upon equitable considerations is *Dudley v. Mealey*.[63] In that case the court granted priority status to a group of unsecured creditors who had furnished supplies to the hotel debtor for a short time preceding the receivership. Since these creditors furnished the goods and services necessary to keep the hotel open, the court deemed them proper preferred claims and separately classified them from the other unsecured creditors.[64] This nonstatutory priority scheme was drawn from the "six months rule" adopted in many railroad reorganization cases,[65] which was also a nonstatutory adjustment of priorities, designed by the courts to keep insolvent railroads running. Affording this type of priority to creditors providing continuing services to a debtor is also a common theme in contemporary chapter 13 cases and will be explored later.

A more recent example of classification and distribution in which equity played its hand was the chapter XII case of *Brinkley v. Chase Manhattan Mortgage & Trust Co. (In re LeBlanc)*.[66] The classification scheme in this real property arrangement placed unsecured creditors in three classes. Small trade

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58. *See* J.P. Morgan & Co. v. Missouri Pac. R.R., 85 F.2d 351 (8th Cir. 1936); *In re* Martin's Point Ltd., 12 Bankr. 721 (Bankr. N.D. Ga. 1981).

59. "On equal footing." BALLENTINE'S LAW DICTIONARY 632 (3d ed. 1969).

60. Act of June 22, 1938, ch. 575, 52 Stat. 840 (amended 1978).

61. 228 U.S. 482 (1913).

62. *See* Pepper v. Litton, 308 U.S. 295 (1939).

63. 147 F.2d 268 (2d Cir.), *cert. denied*, 325 U.S. 873 (1945).

64. *Id.* at 271.

65. Alco Prod. Inc. v. New York, N. Hav. & Hartf. R.R. (*In re* New York, N. Hav. & Hartf. R.R.), 405 F.2d 50, 51 (2d Cir.), *cert. denied*, 394 U.S. 999 (1968); *In re* Penn Cent. Transp. Co., 458 F. Supp. 1234, 1319–21 (E.D. Pa. 1978), *aff'd*, 596 F.2d 1154 (3d Cir. 1979).

66. 622 F.2d 872 (5th Cir. 1980).

creditors holding claims of two hundred dollars or less were to be paid in full. Other trade creditors holding claims greater than two hundred dollars were to be paid forty percent of their claims. Unsecured creditors who were also insiders of the debtor were to be paid nothing under the plan.[67]

Despite the charge that the proposed classification scheme was arbitrary and discriminatory, the court based confirmation on two grounds. First, no equity in the debtor's property existed for distribution to unsecured creditors, and, therefore, the insiders who took nothing under the plan would have taken nothing in liquidation. The court also noted that the great majority of insiders approved the plan.[68]

The second ground for confirmation spoke more to equitable considerations. Since the trade creditors had advanced goods and services to the debtor in the ordinary course of business without knowledge of the debtor's financial condition, and since the trade creditors were to continue to supply the debtor with goods and services, it was reasonable that they should be classified separately and receive forty percent of their claims. In contrast, it was presumed that insiders loaning money to a debtor were in a position to know the debtor's financial condition and the associated risks in loaning money. Also important to the court's determination were the insiders' plans not to have any ongoing relationship with the debtor after confirmation.[69]

The chapter X case of *In re Four Seasons Nursing Centers of America, Inc.*[70] is a similar example of equity in motion. This case concerned the classification of shareholders who had purchased their shares prior to the filing of the petition, unlike those who purchased their shares after the petition was filed. The former group, designated "Class G" creditor-stockholders, was allowed to participate in the reorganization; the latter group, designated "Class E," was deemed to have no economic claim against the debtor and, therefore, was barred from participation. As a result of this classification scheme, the Class E shareholders appealed the lower court's order approving the plan. In affirming this order the court of appeals cited *Collier on Bankruptcy* for its authority to discriminate between the two groups and stated: "The reorganization court as a court of equity has broad powers in the matter of classifying creditors and shareholders, and it necessarily has full power to subordinate interests or classes of interests where the equities demand."[71]

Again, the facts provided an appropriate setting for the court to exercise its equitable powers, since undoubtedly stockholders purchasing their equity

67. *Id.* at 875.

68. *Id.* at 879.

69. *Id.* Nonetheless, one must compare these standards of permissible discrimination to the stringent standards for equitable subordination of the insiders' claims, *e.g.*, Spach v. Bryant, 309 F.2d 886, 889 (5th Cir. 1962). While the equities in *LeBlanc* may have justified separate treatment akin to subordination, they may not have justified actual subordination of the insiders' claims.

70. 472 F.2d 747 (10th Cir. 1973).

71. *Id.* at 749.

interest after the petition was filed were on notice of the debtor's financial difficulties.

Although the bankruptcy courts as courts of equity always have considered the equities of the situation and have subordinated claims when appropriate,[72] it was not until the current Code was enacted that a comprehensive provision on subordination emerged. Section 510(c)(1) provides that "the court may—(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest . . . ."[73]

While this section of the statute relates specifically to equitable subordination, the legislative history indicates that the court's power is broader than the general doctrine of equitable subordination and encompasses subordination on any equitable grounds.[74] Again, the legislative history acknowledges that this section codifies prior case law. However, as *Collier on Bankruptcy* points out, the Code fails to address the issue whether claims that are equitably subordinated must be classified separately for purposes of the plan. *Collier on Bankruptcy* opines that "such classification would not appear to be necessary in all cases"[75] and further points out the problems inherent in separate classification. Specifically, if a subordinated creditor were classified separately, consent from that class might not be forthcoming and the proposed plan would have to comply with section 1129(b)(2)(B) to be confirmed over the objection of the subordinated class. Therefore, the subordinated claims may be classified with other claims and bound by the requisite majority of the class. The court then may enforce the subordination for the benefit of other claims in the class.[76]

Aside from the equitable and statutory considerations leading to subordination, contractual subordination was recognized under the prior Act and now is codified in section 510(a) of the Code, which states: "A subordination agreement is enforceable in a case under this title to the same extent such agreement is enforceable under applicable nonbankruptcy law."[77]

Again, a reading of prior case law reveals the source of this codification and the importance of preserving consensual arrangements. *St. Louis Union Trust Co. v. Champion Shoe Machinery Co.*[78] is one example in which the Eighth Circuit reversed a lower court ruling confirming a plan of reorganiza-

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72. *E.g.*, Pepper v. Litton, 308 U.S. 295 (1939).

73. 11 U.S.C. § 510(c)(1) (Supp. IV 1980).

74. 124 CONG. REC. 11,095 (1978); 124 CONG. REC. 17,412 (1978).

75. 5 COLLIER ON BANKRUPTCY ¶ 1122.03[7] (L. King 15th ed. 1982).

76. *Id.* Another common theme in the subordination arena, as it relates to a classification scheme, concerns stock transfers claimed after the fact to be fraudulent. *See* Fleeger v. Ames, 120 F.2d 803 (10th Cir. 1941). Under the Code this type of situation would be governed most likely by the statutory subordination section of 510(b). *See* 11 U.S.C. § 510(b) (Supp. IV 1980).

77. 11 U.S.C. § 510(a) (Supp. IV 1980).

78. 109 F.2d 313 (8th Cir. 1940).

tion that placed all bondholders in a single class. Specifically, the court determined that when a corporation had issued bonds due in 1932, 1933, and 1934, and bonds due in 1932 had been paid and extension agreements were made in 1933 and 1934, holders of the bonds due in 1933 who consented to the first extension but not to the second were entitled to separate classification and, by the terms of the trust indenture, were subordinated to those who never consented to any extension. They were, however, superior to those who consented to the last extension.[79]

While all the bonds were secured by the same pledged assets under the same trust indenture, the court held that the rights of the respective parties were sufficiently distinct to warrant separate classifications. It reasoned that agreements between creditors to subordinate their indebtedness to that of other creditors should be given effect in bankruptcy proceedings in terms of separate classifications in order to preserve the sanctity of those agreements.[80]

In similar fashion, the court in *Bartle v. Markson Bros, Inc.*,[81] rejected creditors' objections to a plan that provided full payment in cash and notes to holders of debentures subordinated by contract to the claims of other unsecured creditors. The other unsecured creditors were to be paid forty-seven percent of their claims in cash. Since the creditors had been advised of the subordinate status of the debentures prior to their acceptance of the plan, and since the amount to be received under the plan compared favorably with any settlement in liquidation proceedings, the court supported the referee's finding that the arrangement was in the best interests of the creditors.[82]

While the underlying considerations for proposing payment to the subordinated creditors of fifteen percent in cash and eighty-five percent in notes, as compared with the all-cash offer to the general unsecured creditors, are unclear from the opinion, it may be that this classification and priority treatment was designed to obtain class acceptance. The court condoned the arrangement since the senior creditors were advised that the debentures were subordinated before a majority of them accepted the plan, and it also acknowledged that these senior creditors must have thought it wise to approve a plan giving them almost half of their claims at once, even though the plan promised eventual payment in full to the subordinated claims. The court itself questioned their reasoning, but announced that the arrangement was not necessarily erroneous in law.[83] Accordingly, the lesson of *Bartle*, succinctly stated by the court in *In re McKenzie*,[84] is that "where each of two classes is unsecured, but one is by contract subordinated to the other, they have dif-

79. *Id.* at 315–16.
80. *Id.*
81. 314 F.2d 303 (2d Cir. 1963).
82. *Id.* at 305.
83. *Id.* at 305–06. The case was, however, reversed and remanded on another issue. *Id.*
84. 4 Bankr. 88 (Bankr. W.D.N.Y. 1980).

ferent rights in whatever property of the estate is available for unsecured claims."[85]

In re Discon Corp.[86] is another example of separate classification of unsecured creditors under a chapter XI plan in which a subordination agreement was concerned. An indenture in that case contained a clause that provided for subordination in the event of reorganization or liquidation. However, the plan itself ignored the subordination agreement and proposed identical treatment of all unsecured creditors. Consequently, the appellate court set aside the order that confirmed the plan of arrangement, holding that the plan would not be in the best interests of all creditors because the unsecured creditors could not be treated on a parity with one another without violating the subordination provision.[87]

As these cases make clear, classification by subordination, as practiced by the bankruptcy courts sitting as courts of equity, has taken its place in the Code and deserves important consideration by a plan proponent when formulating a classification scheme.

B. *Voting Considerations*

Perhaps the most important criterion influencing a proponent's classification scheme is the potential voting power of the claimants. Courts reviewing classification schemes should be acutely aware of this factor, since gerrymandering of claimants and classification for voting purposes may assure plan acceptance. Courts in the past have not been blind to this problem, and commentators have suggested that creditors whose voting interests are apart from the rest should be classified separately, even though under the plan the separate classes may be entitled to identical treatment.[88]

This concept of separate classification based on voting considerations was hinted at by the court in *First National Bank v. Poland Union.*[89] In this case two of the largest creditors, who were also shareholders, voted in the creditor class to accept a plan of reorganization. Wearing their creditor hats in the voting arena allowed them to profit considerably as shareholders through a release of their disputed liability. The court recognized this problem: "In such circumstances, it may be doubtful whether they should be permitted to vote in the same class with other creditors not so intimately connected with the enterprise."[90] This concept has been explicitly adopted as part of the good faith test of section 1126(e).

Poland Union was cited with seeming approval in *American United Mutual Life Insurance v. City of Avon Park.*[91] This case turned on the manipu-

85. *Id.* at 90.
86. 346 F. Supp. 839 (S.D. Fla. 1971).
87. *Id.* at 845.
88. 6 COLLIER ONBANKRUPTCY ¶ 9.10, at 1605–06 (J. Moore 14th ed. 1978).
89. 109 F.2d 54 (2d Cir.), *cert. denied*, 309 U.S. 682 (1940).
90. *Id.* at 55.
91. 311 U.S. 138 (1940).

lative potential of classification of claimants in a municipal composition under chapter IX of the Chandler Act. The applicable statute provided:

> [T]he judge shall classify the creditors according to the nature of their respective claims and interests: *Provided, however,* That the holders of all claims, regardless of the manner in which they are evidenced, which are payable without preference out of funds derived from the same source or sources shall be of one class.[92]

The Supreme Court recognized that voting in a single class may be inequitable and rejected the view that the sole criterion for classification was prior economic status.[93] In so doing, it seemed to eschew the reasoning of *J. P. Morgan & Co. v. Missouri Pacific Railroad,*[94] in which the nature of the claimant and its bias were rejected as appropriate considerations and inquiry into the motives of those obtaining assents was prompted. Therefore, separate classification was required if necessary to guarantee that the vote equitably represented the judgment of the creditors.

At least one author has read *City of Avon Park* to permit further classification apart from the provisions of the statute and has suggested that it could apply to other chapters as well.[95]

As these cases point out, creditors within one class may have substantially similar claims but dissimilar interests in the fate of the debtor. The more difficult problem the courts may face under the Code is the classification of dissimilar claims in the same class for the purpose of drowning out a particular voice in order to guarantee acceptance of the plan.

C. *Separate Classifications Due to Different Treatment Under the Plan*

A result-oriented criterion frequently used in Act cases to justify separate classification of claims was the different treatment to be afforded the various claimants. Section 1123(a)(4) of the Bankruptcy Code speaks to this aspect of classification: "(a) A plan shall . . . (4) provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest."[96]

Since the "substantially similar" language of chapter 11 has been interpreted not to require that all substantially similar claims be placed in the same class, but only that those claims grouped together in a class be substantially similar to one another,[97] different treatment may be an appropriate reason to classify claimants separately. A number of Act cases suggest that this different treatment is a justifiable criterion for the division of creditors.

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92. Act of Aug. 16, 1937, ch. 657, 50 Stat. 653, 656 (amended 1938) (emphasis in original).
93. 311 U.S. 138, 143–44 (1940).
94. 85 F.2d 351 (8th Cir.), *cert. denied,* 299 U.S. 604 (1936). *See supra* text accompanying notes 21–26.
95. Note, *Equity Power of Bankruptcy Courts Over Classification and Assignment of Claims,* 50 YALE L.J. 892 (1940).
96. 11 U.S.C. § 1123(a)(4) (Supp. IV 1980).
97. 5 COLLIER ON BANKRUPTCY ¶ 1122.03[1] (L. King 15th ed. 1982).

One of the classic statements on this issue was offered by the court in *Kyser v. MacAdam*.[98] This chapter XII proceeding concerned a priority dispute between a mortgagee and the holder of a mechanic's lien on the same property. Before reversing and remanding the case the court determined that the mortgage and materialmen's liens were not on a parity with one another and should not be classified together. Taking a result-oriented approach, the court held that "a different treatment in the plan of claims of even the same economic status requires separate classification."[99]

In another case concerning secured creditors, the court in *Mokava Corp. v. Dolan*[100] refused to allow two first mortgages to be lumped together in the same class. The debtor in *Dolan* was a hotel corporation, the creditors of which held mortgages against the hotel. Of the two mortgages grouped together, one secured the so-called main building, and the other the annex. While the court recognized that the holder of the first mortgage on the annex had purchased the mortgage with an intent to thwart acceptance of the plan, the central issue revolved around the single classification that included two first mortgages slated to receive substantially different treatment in the proposed plan. Not only was the initial classification incorrect because the mortgages were secured separately on two different buildings, but as the court pointed out, "the error here was aggravated when the court approved a plan according very substantially different treatment to the two mortgages" that were lumped together in the same class.[101] This conflicts with the *Palisades-on-the-Desplaines*[102] holding on the separate classification of first mortgages. The conflict is based more upon the discriminatory treatment within the single class of creditors than on the classification itself. Had the plan provided equal treatment to both creditors, the court might have accepted joining both creditors in a single class.

The Ninth Circuit took a similar result-oriented approach in *West Coast Life Insurance v. Merced Irrigation District*[103] in the context of a chapter IX composition. There, disputed classification arose from a single class containing both matured and unmatured bond obligations. Contrary to *Kyser* and *Mokava*, the court determined that one class was appropriate when all were to be paid from the same source, citing Remington's treatise for the proposition that "the fundamental classification must be in accordance with the source or fund out of which the payment is intended to be made."[104] The court only paid lip service to the idea of separate classification when it said, "Of course every bond of different maturing date and every interest coupon is in a sense in a

98. 117 F.2d 232 (2d Cir. 1941).
99. *Id.* at 237.
100. 147 F.2d 340 (2d Cir. 1945).
101. *Id.* at 344.
102. 89 F.2d 214 (7th Cir. 1937). *See supra* text accompanying notes 34–43.
103. 114 F.2d 654 (9th Cir. 1940).
104. H. REMINGTON, A TREATISE ON THE BANKRUPTCY LAW OF THE UNITED STATES § 4361 (1939).

class by itself, but no one would contend that this difference is within the meaning of the bankruptcy law a mark for classification."[105]

The Ninth Circuit underscored its support of the separation of claims for separate treatment three years later in *Western Mesa Oil Corp. v. Edlou Co.*[106] The court confirmed an arrangement that gave one class of unsecured claims priority over another when the favored class was owed past-due royalties on a lease. To secure the consent of these unsecured claimants the debtor provided that this class be paid in full in the same manner as true priority claims. Among other arguments, the appellants claimed that this division of unsecured creditors was invalid because it gave one class of unsecured claims priority over another. Citing section 357 under chapter XI for authority to divide claims into separate classes and to treat them in different ways, the court affirmed the judgment of the district court.[107]

In similar fashion, *In re Boston Metropolitan Buildings, Inc.*[108] stands for the proposition that separate treatment of creditors justifies separate classification under a chapter X plan. Since the creditor in question, New England Theatres, Inc., was receiving different, less favorable treatment than other security holders, separate classification was warranted.[109]

One of the most recent cases containing classification of claims on the basis of different treatment is *In re Jaco Fabrics, Inc.*[110] This case concerned a chapter XI plan of arrangement that divided the nonpriority unsecured debts into two classes, one of which contained debts of three hundred dollars or less. The remainder of the unsecured creditors were placed in "Class 4." The plan provided that certain Class 4 claims were not to be affected by the plan, but were to be paid outside the arrangement, and it was silent on the other Class 4 claims. The effect of this provision was that the remaining creditors would receive 22½ cents on the dollar, while the others were to be paid outside the plan.[111]

Citing section 357 of chapter XI, the court recognized that unsecured claims could be divided into classes and accorded different treatment. However, this difference in treatment must be "just and reasonably necessary to effectuate the arrangement."[112] By classifying the creditors in Article I of the plan and then excluding from Article I classes those creditors in Article III, any reasonable classification of creditors was destroyed, and the court denied confirmation on this basis.[113] This tactic of segregating creditors and attempting to pay off some outside the plan is a prevalent theme in chapter 13 cases and will be discussed in more detail later.[114]

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105. 114 F.2d 654, 672 (9th Cir. 1940).
106. 143 F.2d 843 (9th Cir.), *cert. denied*, 323 U.S. 786 (1944).
107. *Id.* at 845–46.
108. 92 F. Supp. 843 (D. Mass. 1950).
109. *Id.* at 848.
110. 3 BANKR. CT. DEC. (CRR) 1301 (Bankr. N.D. Ga. Jan. 5, 1978).
111. *Id.* at 1301–02.
112. *Id.* at 1302.
113. *Id.*
114. *See infra* text accompanying notes 133–38.

Perhaps the most intriguing question about separate classification arising from different plan treatment is whether treatment of such groups is meant to be comparable or equal though different, and if so, whether it actually is discriminatory. This determination will depend on a number of factors. As one example, the court in *In re Celotex Co.*[115] allowed holders of debentures, as investors, to be given notes of longer maturity than the notes given merchandise creditors.[116]

IV. Those "Few Immutable Principles"

Having surveyed a representative sample of case law under the Act to divine the appropriate criteria for classification of claims, what general principles have emerged?

The first principle apparent from the construction of the statute and past case law is the threshold for classification: the fundamental division between equity interest holders and creditors. Beyond this, secured and unsecured claims are to be classified separately. Unsecured creditors may be divided into classes when the legal character or effect of their claims accords rights and priorities against the debtor's property in a liquidation setting different from those of other unsecured creditors. Shareholders may be divided further into preferred and common, depending on the nature of interests presented, and it is possible that these categories may be divided further. To determine these further classifications, one may rely on the general rule that "[c]reditors of a kind and of equal rank, with claims against the same property, should be placed in the same class, while creditors of a kind but of different ranks, and creditors of the same kind and rank but with claims against different properties, should be separately classified."[117]

Other determinants of classification in the past have revolved around contractual subordination, equitable considerations, voting concerns, and different treatment accorded claimants in the plan. These general determinants become less immutable when one considers the warning that these "generalizations must be applied in light of specific facts, and rules must be construed in the light of the respective circumstances . . . ."[118]

The real question becomes how these few "immutable principles" will fare in light of recent changes in the bankruptcy law, or more specifically, what changes effected by the enactment of the Code will have a bearing on the classification of claims and interests.

V. Changes in the Code Affecting Classification

Since the Bankruptcy Code became effective on October 1, 1979, few reported chapter 11 cases have reached the classification issue. Accordingly, one can only speculate about the long term effects of the changes made by the

115. 12 F. Supp. 1 (D. Del. 1935).
116. *Id.* at 5.
117. 6 COLLIER ON BANKRUPTCY ¶ 9.10, at 1601 (J. Moore 14th ed. 1978).
118. *Id.* at 1595.

new Code. However, a cursory look at a few of the changes may prove helpful in predicting the course of the future.

One obvious difference between the Act and the Code is the withdrawal of the judge's power to classify claims. Under the Code the debtor is afforded that right during the exclusivity period,[119] although creditor input is important. The judge no longer may classify claims, and the only recourse available to the judge is to withhold confirmation under section 1129(a)(1) when the plan does not comply with the applicable provisions of the chapter, namely, section 1122 on classification. By the same token, a creditor who is outvoted in his class also may oppose plan confirmation under section 1129(a)(1).

Because the "fair and equitable" determination by the court becomes operative only in the event of a cramdown,[120] it is foreseeable that class manipulation may be attempted simply to outvote disgruntled creditors.[121]

An examination of classification problems emerging under chapter 13 of the Code may shed additional light on changes between the Act and the Code and illuminate the path to be followed in chapter 11 reorganizations.

VI. Classification of Claims Under Chapter 13 of the Code

To understand the classification criteria set out in section 1122, it may prove useful to look at the chapter 13 cases decided under the Code that directly address this issue. Since chapter 13 explicitly incorporates the standards set forth in chapter 11,[122] these recent chapter 13 cases may be indicative of what one can expect in a chapter 11 classification problem.

While a strong sentiment exists among scholars and professionals working in the field that chapter 13 plans should not influence classification schemes in chapter 11 cases because the two chapters are different species,[123] the fact remains that chapter 13 standards are derived from chapter 11. Even more to the point, the same judges now wrestling with classification issues in chapter 13 cases will be called upon to resolve the disputes as they arise in chapter 11 cases, and they cannot be expected to interpret the same words of the same statute differently because a different chapter of the Code is concerned.

The chapter 13 provisions relevant to classification of unsecured claims state:

> (a) The Plan shall—
>
> . . . .

119. 11 U.S.C. § 1121(b) (Supp. IV 1980).

120. 11 U.S.C. § 1129(b) (Supp. IV 1980). A cramdown is the confirmation by a court of a classification plan over the dissent of a class of claims or ownership interests. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133, 134 (1979).

121. For an unsuccessful attempt to cram down a plan over the objections of disgruntled creditors, see *In re* Landau Boat Co., 8 Bankr. 432 (Bankr. W.D. Mo. 1981).

122. 11 U.S.C. § 1322(b)(1) (Supp. IV 1980).

123. Epstein, *Chapter 13: Its Operation, Its Statutory Requirements as to Payment to and Classification of Unsecured Claims, and Its Advantages*, 20 WASHBURN L.J. 1, 17 (1980).

(3) if the plan classifies claims, provide the same treatment for each claim within a particular class.

(b) Subject to subsections (a) and (c) of this section the plan may—

(1) designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated; . . . .[124]

The statute sets up three criteria by which claims may be classified. The first criterion states that the treatment provided for each claim within a class must be the same. It encompasses part of section 1123(a)(4) of chapter 11 and establishes that different treatment of claims within the same class would have the effect of creating separate classes.

The second criterion to be considered in the classification of claims directly injects the standards of chapter 11 by requiring that a claim or interest in a particular class be "substantially similar" to other claims or interests of the class. As noted earlier, this does not mean that all substantially similar claims must be placed in the same class. It only means that the claims within any particular class must be substantially similar to one another.

The third criterion, which provides that there may be no unfair discrimination against a designated class, is the criterion upon which the courts focus most often when a classification problem arises. Although no parallel requirement exists in section 1122, this criterion becomes a consideration in chapter 11 when the plan is not accepted by all classes and the plan proponent has requested the court to cram down the plan over creditors' objections under section 1129(b)(1).

In analyzing section 1322 and case law decided under that section, it should be noted that chapter XIII of the Act did not permit separate classification of unsecured claims with different treatment accorded the separate classes. Therefore, the courts have had to interpret the new chapter 13 sections to determine whether and to what extent a classification scheme may be approved. As under chapter 11, this process concerns consideration of case law under the Act as codified in section 1122 of the Code. Since "few immutable principles" can be extracted consistently from the cases, the courts have found classification problematic. As a result, interpretations have been as varied as their representative fact patterns, and there is still little agreement concerning general rules. Despite the inconsistencies, a review of classification cases under chapter 13 will demonstrate the flexibility of the law and its possible future directions under chapter 11.

The chapter 13 cases to date fall into two basic sets. The common bond that exists in the first set of cases is court confirmation of a plan in which claims were classified separately either within the plan or through payment outside the plan. The second set of cases reaches the opposite result, denying confirmation because of "unfairly discriminatory" claims classification. The

124. 11 U.S.C. § 1322 (Supp. IV 1980).

differences between the two sets of cases illustrate the tension between the principles of equality on the one hand and the politics of the reorganization process on the other hand.

Within the broad category of the first set of cases, recurring themes are evident: comparison of payments under the plan to payments on liquidation; allowances for payments of nondischargeable debts; and allowances for payments of cosigned debts. Perhaps the most liberal approach to the classification issue was that taken by the court in *In re Sutherland*.[125] This court held that the debtor could place unsecured medical debts, bank notes, and credit accounts needed for continuation of the debtor's business in separate classes and make payments to those classes to assure continued medical treatment and continued credit for the debtor's business. The remainder of the unsecured creditors were placed in a separate class that would not be paid.[126]

The court discussed the rational basis classification criteria set up by several other courts and held that the debtor's classification of claims and proposed payments was rational since the payments to the favored class assured the continuance of the debtor's business and his continued health necessary to operate his business. Addressing the unfair discrimination issue, the court summarily concluded that "there [cannot] be an unfairly discriminatory classification against any class of unsecured creditors when unsecured creditors would not receive anything in the event of liquidation in a Chapter 7."[127]

The court further reasoned that it made "no sense to have a system that prevents them from paying one or more unsecured creditors of their choosing" under "circumstances where the debtors do not have to pay anything to any unsecured creditors."[128] It went overboard in its reasoning by announcing that "this court would allow a classification for unsecured creditors whose credit managers have redheaded secretaries."[129]

As the court pointed out in *Sutherland*, one fairness standard to which some courts adhere is a comparison of what the discriminated class would receive under a straight bankruptcy. Under this standard, if the disfavored class may be receiving some percentage under the proposed plan and would receive nothing under chapter 7, separate classification and different treatment may not be unfair. If the debtor is not permitted to discriminate, the debtor may be forced to file under chapter 7 and those creditors would still receive nothing. The courts also consider that the debtor could have filed under chapter 7 but chose not to.[130] Thus, such classifications are not ipso facto unfair discrimination.

125. 3 Bankr. 420 (Bankr. W.D. Ark. 1980).
126. *Id.* at 421.
127. *Id.* at 422.
128. *Id.*
129. *Id.*
130. *See In re* Haag, 3 Bankr. 649 (Bankr. D. Or. 1980).

This standard is also evident in *In re Curtis*,[131] in which the court bandied about the rational basis language in its approach to a classification question. It held that a one hundred percent payment on a child-support arrearage and a ten percent dividend to other unsecured creditors was fair because the child support was not a dischargeable debt under section 523(a)(3)(A)(5) and the plan offered the ten percent group of unsecured creditors as much as or more than they would receive on liquidation.[132]

Similarly, the court in *In re Haag*,[133] faced with the same objection to a payment of one hundred percent on a child-support arrearage, held that the plan did not discriminate unfairly since the disfavored class was receiving a twenty-five percent payment. In a chapter 7 these unsecured creditors would receive nothing, and the claim for past child support would be nondischargeable. Therefore, the debtor, by filing a chapter 7, could obtain the same relief as in a chapter 13, without obligating any future income toward payment of the claims of general unsecured creditors. Given this reasoning, the court felt it was not unfair to allow the classification and proposed different treatment.[134]

The court in *Haag* also brought up another important point: whether paying a claim outside a plan itself constitutes a classification. Even this point is contested. The court in *In re Blevins*[135] found that the debtor's election to pay some claims within and some outside the plan constituted a classification, whereas the court in *In re Berry*[136] thought it questionable "whether any payments 'outside the plan' constitut[ed] a designation 'of a class of unsecured claims, as provided in § 1122 . . .'."[137] While a dispute over this point does exist, if the outside payment is deemed to create a classification the court must determine whether the classification unfairly discriminates.[138] Adherence to the principle of equality of treatment for creditors suggests that outside payments should be examined as a *sub rosa* form of classification.

A similar question arose in *In re Wittenmeier*,[139] in which the court reaffirmed one of the few general rules of classification: each secured creditor is normally in a separate class. The court allowed the debtor to pay a secured lender outside the plan.[140]

Also in this same line of cases are *In re Hill*[141] and *In re Garcia*.[142] Both dealt with the separate classification of a cosigned debt for the purpose of paying that particular creditor more than other unsecured creditors. In *Garcia*

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131. 2 Bankr. 43 (Bankr. W.D. Mo. 1979).
132. *Id.* at 44-45.
133. 3 Bankr. 649 (Bankr. D. Or. 1980).
134. *Id.* at 651.
135. 1 Bankr. 442 (Bankr. S.D. Ohio 1979).
136. 5 Bankr. 515 (Bankr. S.D. Ohio 1980).
137. *Id.* at 517.
138. 11 U.S.C. § 1322(b)(1) (Supp. IV 1980).
139. 4 Bankr. 86 (Bankr. M.D. Tenn. 1980).
140. *Id.* at 87.
141. 4 Bankr. 694 (Bankr. D. Kan. 1980).
142. 6 Bankr. 35 (Bankr. D. Kan. 1980).

the debtor also separated a debt owed to his attorney on an ongoing nonbankruptcy matter for the purpose of paying that claim in full. All other unsecured creditors in *Garcia* were slated to receive nothing, as they would have in a chapter 7 liquidation. The court cited *Sutherland* in confirming the plan.[143] In *Hill* the debtor created three separate classes of unsecured claims. Aside from the segregation of the cosigned debt into a separate class, the plan classified separately doctors with whom the debtor expected to have future dealings and provided a larger payment to that class. The court confirmed that plan also.[144]

Separate classification of a cosigned debt is another common theme in chapter 13 cases, and it is easy to see why. As Judge Lee points out in his article *Chapter 13 nee Chapter XIII*:

> The reason for wanting to place debts on which codebtors are obligated in a separate class is the fact that the automatic stay against collection from codebtors on consumer debts is operative only to the extent the debt is to be paid under the plan. A creditor may obtain relief from the stay and proceed against the codebtor to the extent the debt is not dealt with by the plan.[145]

If debtors are allowed to classify separately debts on which another person has cosigned to prevent the creditor from proceeding separately against the cosigner (usually a rélative), as Judge Lee points out, smart creditors will "retaliate by requiring the signature of codebtors on all debts."[146]

Despite these ramifications of the separate classification of cosigned obligations, the court in *In re Kovich*[147] reaffirmed this type of separate classification after developing and applying guidelines for determining whether a particular classification scheme was unfairly discriminatory under section 1322(b)(1). The issue before the court in *Kovich* was the propriety of a separate classification of obligations concerning a codebtor and a landlord, slated to receive full payment, when other unsecured creditors were to receive only ten percent in satisfaction of their claims. The court reviewed existing case law, decided that the proposed classification was not fatally defective, and reset the case for confirmation hearings.[148] In one of the better discussions of the criteria to be considered in determining whether a classification unfairly discriminates against unsecured creditors, the court opined:

> Each case must be decided on its own merits. Is there a reasonable basis for the classification? Is the debtor able to perform a plan without the classification? Has the debtor acted in good faith in the proposed classification? Certainly the debtor should not be permitted to pay a creditor less because of ill will. Another consideration must be the treatment of the class discriminated against. Are they receiving a meaningful payment or is the plan just a sham?[149]

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143. *Id.* at 38.
144. 4 Bankr. 694, 700 (Bankr. D. Kan. 1980).
145. Lee, *Chapter 13 nee Chapter XIII*, 53 AM. BANKR. L.J. 303, 313 (1979).
146. *Id.*
147. 4 Bankr. 403 (Bankr. W.D. Mich. 1980).
148. *Id.* at 406–07.
149. *Id.* at 407.

One of the more recent cases allowing separate classifications for unsecured debts was *In re Perskin.*[150] Addressing the outside-the-plan question of classification, the court determined that although section 1322(b)(1) did not literally address discrimination when one claim is being paid outside the plan, the section logically is suited to govern cases in which payments to creditors outside the plan discriminate unfairly. The plan in this case provided for the debtor's retention of two credit cards with payments on the outstanding and future obligations to be handled outside the plan. An objection was filed by a bank, claiming that this arrangement was unfair discrimination against other creditors who were being compensated within the plan.[151]

The court admitted that the plan discriminated between the classes, but held that since the debtor was a travelling salesman it was necessary for him to retain the credit cards to pay his expenses and stay in business. Thus, the debtor treated the two classes differently so the plan would work, and the court found that while discrimination existed, it was reasonable under the circumstances.[152]

Despite the number of cases that allow separate classification of unsecured claims, this first set of cases represents the minority view. Since the Code was enacted, the emerging majority of cases insists upon more equal treatment of creditors. While all these cases are derived from the principle of equality of treatment for creditors, a close reading reveals the same inconsistencies as in the cases condoning classification resulting in unequal treatment. A review of a representative sample of these recent decisions demonstrates the inconsistencies of standards and approaches.

One of the most often cited opinions is *In re Iacovoni.*[153] As in the cases mentioned earlier, the debtor attempted to classify separately an unsecured debt that had been cosigned and to pay this creditor one hundred percent, while paying the remainder of the unsecured creditors nothing.[154]

Citing section 1122 and noting the *Collier on Bankruptcy* interpretation, the court stated that the authorities implicitly required that all nonpriority claims have an equal right to distribution of assets after payment of secured and priority claims. In the court's words, "[T]his would comport with classification based on the legal nature of a claim, all unsecured creditors having similar right, absent some reason for equitable subordination, to the assets of the estate."[155] The court determined that the only exception to requiring all unsecured claims to be classified in a single class, other than equitable subordination, was the administrative convenience exception codified in section 1122(b).[156]

150. 9 Bankr. 626 (Bankr. N.D. Tex. 1981).
151. *Id.* at 628.
152. *Id.* at 632.
153. 2 Bankr. 256 (Bankr. D. Utah 1980).
154. *Id.* at 258.
155. *Id.* at 260.
156. *Id.* The administrative convenience exception is derived from prior practice under chapters X, XI, and XII, permitting full or greater payment of de minimis claims.

In light of this interpretation, the court held that section 1122 did not allow a separate classification of an unsecured debt based solely on the presence of a codebtor. This was an arbitrary classification that the court felt discriminated unfairly. The court recognized and discussed the opposing point of view, and stated it most succinctly:

> Nevertheless, it may be argued with some practical force, that previous case law and present Chapter 11 restrictions ought not apply to Chapter 13 classifications. Unsecured creditors have no vote on the Chapter 13 plan and, therefore, "improper" classification does not compromise voting power as it may in Chapter 11. Furthermore, since there is arguably little obvious incentive or requirement that Chapter 13 debtors pay anything to unsecured creditors (assuming those creditors would receive nothing in Chapter 7 liquidation), any classification of unsecured creditors may result in at least payment to some creditors who otherwise might receive nothing. Finally, the objective of broad debtor's relief is compromised if separate classification of co-obligor debts is not allowed.[157]

The court found this argument unpersuasive:

> Chapter 13 classification is tied directly to Chapter 11 classification restrictions by 11 U.S.C. §§ 1322(b) (1) and 1122 as noted earlier. This direct tie reflects a legislative intent to adopt existing classification restrictions and to provide some protection to the unsecured Chapter 13 creditor precisely because the creditor has no vote. This protection is particularly critical to the significant creditor of the Chapter 13 business debtor whose subordination to personal or business codebtor debts might effect a substantial injustice and, indeed, a future proclivity by lenders to demand a cosigner. The broad relief of Chapter 13 has its limits. Therefore, the Court now holds that an unsecured debt classified separately and treated differently solely on the basis of the existence of a codebtor is an improper classification under 11 U.S.C. § 1322(b) (1).[158]

Confirmation also was denied in a number of other cases based on the separate classification of a codebtor. The court in *In re Fonnest*[159] held that no reason existed to differentiate a codebtor note. The court in *In re Montano*[160] held that a separate classification of unsecured debts solely on the basis of the existence of cosigners was an improper classification. In *In re Utter*[161] a debt cosigned by a relative was placed in a separate class with the expectation of receiving one hundred percent of the claim, while the other unsecured creditors had expectations of little or nothing. In concurring with *Iacovoni* and holding that the disparity of treatment between the classes was unfairly discriminatory, the court held: "The existence of a co-debtor does not change the nature of the debt itself nor does it alter that debt's position in respect to its claim on the debtor's assets."[162]

157. 2 Bankr. 256, 261 (Bankr. D. Utah 1980).
158. *Id.*
159. 1 COLLIER BANKR. CAS. 2d (MB) 383 (Bankr. N.D. Cal. Jan. 25, 1980).
160. 4 Bankr. 535 (Bankr. D.D.C. 1980).
161. 3 Bankr. 369 (Bankr. W.D.N.Y. 1980).
162. *Id.* at 369.

The court in *In re Wade*[163] also followed the lead of *Iacovoni* in refusing to confirm a plan in which an unsecured debt that had been cosigned was relegated to a class of its own and favored over other unsecured debts. The court determined that the only difference between the debts was the different treatment accorded the creditors.[164]

In re Crago[165] is another example of a failure of plan confirmation as a direct result of separate classification of a debt that had a cosigner. The court recognized the problems inherent in bankruptcy when a cosigned debt is involved and indicated that there may be "other methods by which the co-signed debt can be handled within the ambit of a Chapter 13 proceeding which will protect both the debtor and the individual who has co-signed for the debtor without unfairly classifying these claims."[166] Unfortunately, the court offered no suggestions.

These issues were analyzed again at length in *In re McKenzie*.[167] Once again, the court refused confirmation of a plan that separately classified a debt with a cosigner and provided full payment to that class. In refusing to confirm the plan, the court discussed the prior case law codified in section 1122 and concluded that any classification of unsecured creditors would discriminate. However, the court did not condemn discrimination per se, but asked whether the discrimination was unfair under section 1322(b)(1). It then determined that all unsecured creditors have the same rights vis-à-vis property of the estate and that the existence of a third-party guarantor on an obligation does nothing to change the nature of the claim against the estate. Accordingly, it held that allowing the claim more than a pro rata share in the estate would discriminate unfairly against the remaining unsecured creditors.[168]

The court also recognized that its holding would create practical problems while upholding the principle of equality of treatment of creditors:

> As to the argument that the Court's interpretation of the power to classify will foster extra-judicial arrangements by Chapter 13 debtors to protect their standing amongst friends, relatives and co-workers, the Court can only point out that that is a problem to be addressed by the debtor in fashioning his plan, or by Congress if it sees fit.[169]

As the court correctly observed, the debtor's inability to classify claims within the proposed plan according to whether there is a codebtor on that debt may result in the debtor's paying that creditor outside the plan. As noted earlier, however, many courts recognize this tactic to be the same as classifying claims and require that it pass muster as a classification scheme under

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163. 4 Bankr. 98 (Bankr. M.D. Tenn. 1980).
164. *Id.* at 100.
165. 4 Bankr. 483 (Bankr. S.D. Ohio 1980).
166. *Id.* at 484.
167. 4 Bankr. 88 (Bankr. W.D.N.Y. 1980).
168. *Id.* at 91.
169. *Id.* at 91–92.

section 1322(b)(1). And while the courts in *Hill*[170] and *Garcia*[171] allowed the payment of cosigned and other debts outside the plan, in general the courts frown on this type of special treatment. If nothing else, they subject the debtor's classification scheme to the unfair discrimination test.

The court's opinion in *In re Blevins*[172] sheds light on the practice of excluding certain creditors from a plan by discussing the prior chapter XIII. According to the court, under chapter XIII claims secured by estates in real property or chattels real were not claims within the ambit of chapter XIII and, therefore, could not be included in the proceeding. Thus, the practice developed that certain secured creditors were treated outside the plan. The facts in *Blevins*, however, concerned a partially secured creditor to be paid outside the chapter 13 plan. The court found no legislative approval of this practice and was forced to conclude "that all claims should, and perhaps must, be treated within the terms of the proposed plan, unless substantial justification is provided for exclusion of a claim from the plan provisions."[173]

Thus, instead of determining that payment of a claim outside a plan consituted a classification that then required a determination whether one class was being discriminated against unfairly, the court reached the same result by falling back on section 1322(a)(3), which requires equal treatment for each claim in a particular class. The court, therefore, found that certain creditors outside the plan, who were supposed to be in the same class with claims of a similar nature inside the plan, actually were receiving better treatment. The court then refused confirmation because of unfair discrimination. In carefully analyzing the proposed payments to the classes under the plan, the court recognized its important role and expressed the following *caveat* to other courts looking at classification problems under chapter 13:

> A creditor, or class of creditors, dissatisfied with the classification of claims in a Chapter 11 proceeding may opt to vote to reject the provisions of the plan. This option is not available, however, in Chapter 13. The inability of a Chapter 13 claimant holding an unsecured claim to vote to accept or reject a Chapter 13 plan places a greater burden on the Court to scrutinize the classification of claims as chosen by the debtor and confirm only those plans where the classification chosen does not discriminate unfairly against any creditor.[174]

This is the better approach to the outside-the-plan problem, because the principle of equality of treatment demands consideration of all payments to creditors, whether inside or outside a formal plan, to determine whether the plan is unfairly discriminatory.

In a companion decision to *Blevins*, Judge Sidman in *In re Tatum*[175] refused to confirm a plan that proposed payment to three partially secured

170. *In re* Hill, 4 Bankr. 694 (Bankr. D. Kan. 1980).
171. *In re* Garcia, 6 Bankr. 35 (Bankr. D. Kan. 1980).
172. 1 Bankr. 442 (Bankr. S.D. Ohio 1979).
173. *Id.* at 444.
174. *Id.*
175. 1 Bankr. 445 (Bankr. S.D. Ohio 1979).

creditors outside the plan. Since there was no rational explanation why some claims should be paid outside the chapter 13 plan, the judge could see no reason why similarly situated creditors should not be given equal treatment.[176] The judge even expressed surprise concerning the proposed outside-the-plan payments on the basis of section 1328, which warns that debts not provided for by the plan are not discharged.[177]

Classification of claims within a plan can fail the unfairly discriminatory test of section 1322(b)(1), as shown by the codebtor cases previously cited and by those that follow. *In re Fizer*[178] was another decision by Judge Sidman in which he refused to allow a partially secured creditor to receive payment on the unsecured and secured portions of his claim because other unsecured creditors did not fare so well.[179]

In *In re Gay*[180] the plan established two classes of unsecured claims, one group to whom the debtor had issued bad checks and the other that included all other unsecured claims. The court deemed the debtor's plan to pay the first group one hundred percent of their claims and the second group two percent of theirs unfairly discriminatory under section 1322(b)(1) despite the possible threat of criminal proceedings by the creditors holding the bad checks.[181]

The court in *Gay* took issue with the *Iacovoni* court's delineation of only two exceptions to uniform classification of unsecured claims. Although the *Gay* court refused to allow the separate classification scheme proposed by the debtor, it took the more liberal position that separate classification of unsecured creditors is permissible and different treatment accorded to the classes is allowed unless unfair discrimination exists, suggesting that "the determination of what constitutes unfair discrimination requires a view of the nature of the claims in each proposed class and the treatment to be accorded them."[182] Besides these statutory criteria, the court injected its own equitable criteria:

> Other factors must be taken into account, such as the creditor's rights, if any, against third parties and the importance of the classification to the debtor's "fresh start," and to his ability to perform under the plan. The propriety of each proposed classification should be considered with reference to the facts of the case. Sound judicial discretion should be exercised in determining whether, from both the creditor's and debtor's point of view, a proposed classification is unfairly discriminatory.[183]

In another 1980 decision, *In re Blackwell*,[184] the court sidestepped a finding on the question of unfair discrimination by holding that the proposed plan

176. *Id.* at 446.
177. *See also In re* Weeden, 7 Bankr. 106 (Bankr. D.R.I. 1980).
178. 1 Bankr. 400 (Bankr. S.D. Ohio 1979).
179. *See also In re* Cooper, 3 Bankr. 246 (Bankr. S.D. Cal. 1980).
180. 3 Bankr. 336 (Bankr. D. Colo. 1980).
181. *Id.* at 338.
182. *Id.* at 337.
183. *Id.* at 338.
184. 5 Bankr. 748 (Bankr. W.D. Mich. 1980).

did not meet the good faith standard of section 1325(a)(3). The plan in this case proposed a five percent distribution to unsecured creditors except for the debtor's landlord, who was to receive one hundred percent of his unpaid rent. In denying confirmation of the plan, the court conceded that "a plan which does not give unsecured creditors a 'good faith' amount cannot be called 'fair.'"[185]

Continuing in this same vein is a recent Texas decision, *In re Dziedzic.*[186] Confirmation was denied at the trustee's request because of the separate classification and treatment of the unsecured claim of the debtor's credit union. This creditor was slated to receive one hundred percent, while the remaining unsecured creditors were to be paid twenty-six percent of their claims. The debtor claimed that the credit union should be treated differently because his failure to pay this debt completely would harm his job standing as a police officer, subject him to social embarrassment, and put him in jeopardy of physical abuse. After discussing other case law in this area the court denied confirmation because "the degree of discrimination is high; the justification for it insufficient."[187]

Despite the disparate holding on this particular issue, a close reading of the cases reveals evolving standards for determining whether a classification scheme discriminates unfairly. These standards are as follows:

(1) Whether the discrimination has a reasonable or rational basis;
(2) whether the debtor can carry out a plan without discrimination;
(3) whether the discrimination is proposed in good faith;
(4) whether the difference in treatment is severe or inconsequential; and
(5) whether the class being discriminated against is receiving a meaningful payment.

Despite the lack of guidance provided by the statute, the courts have enunciated these standards in the realization that no hard-and-fast rules can exist when each classification scheme must turn on the particular facts of the case. This approach taken by the courts was most accurately described by Professor Epstein when he noted that classification of claims under chapter 13 "presents problems of interpreting cryptic statutory language and balancing competing policy considerations."[188] The competing policy considerations here, as elsewhere in reorganization law, are the principle of equality of treatment on the one hand, and on the other hand, the pressures to differentiate between creditors for economic or other practical reasons.

Competition between these policies may be more pronounced in chapter 13 cases because the individual chapter 13 debtor is a more sympathetic figure than a corporate chapter 11 debtor engaged in major business activities and

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185. *Id.* at 751. Decisions on plan confirmation on the basis of good faith alone are abundant, but need not be dealt with here.

186. 9 Bankr. 424 (Bankr. S.D. Tex. 1981).

187. *Id.* at 427.

188. Epstein, *Chapter 13: Its Operation, Its Statutory Requirements as to Payment to and Classification of Unsecured Claims, and Its Advantages,* 20 WASHBURN L.J. 1, 17 (1980).

because of the smaller dollar amounts at stake in chapter 13 cases.[189] In addition, creditors in chapter 11 cases must vote on the plan;[190] creditors in chapter 13 cases do not. A chapter 11 court may view classification issues more carefully because improper classification may circumvent the voting requirements of chapter 11.

Therefore, chapter 13 cases may raise as many questions as they answer even though they afford a preview of future developments under chapter 11. For this reason, the *Collier on Bankruptcy* statement about classification under the Act is still true: "classification . . . is one as to which few immutable principles can be pronounced."[191]

VII. The Principles Emerge

Nonetheless, some principles do emerge from the synthesis of case law under the Chandler Act and the Bankruptcy Code. If viewed as guides rather than rules, they can assist the debtor or creditor steering through the classification process.

Principle 1: The nature of the claim or interest is based upon the relationship of the claim to the debtor, rather than on the nature or identity of the claim or interest holder.

This is perhaps the most immutable principle, having survived without change through three successive bankruptcy laws. It provides the basis for the initial division of claims from interests; the subdivision of claims into secured, priority, general unsecured, and subordinated unsecured claims; and the subdivision of interests into preferred stock, common stock, warrants, options, and so forth.

The corollary to this principle, as recently enunciated in *Martin's Point Ltd.*, is that since the classification process revolves around the claim and not the claimant, a claimant may be a member of several classes as a result of being both a creditor and an equity interest holder. Just because a creditor also holds a more subordinate interest in the same debtor is not a reason to subordinate his claim to that of a creditor who is not also an equity security holder, or to treat it differently from other substantially similar claims.[192]

Principle 2: Claims of a similar nature need not be classified in the same class.

Notwithstanding judicial reluctance to encourage a multiplicity of classes,[193] neither the Code nor case law requires that all claims of a similar nature be classified in the same class. Small claims may be classified sepa-

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189. Under 11 U.S.C. [109(e) (Supp. IV 1980), a chapter 13 debtor must have noncontingent liquidated unsecured debts of less than $100,000 and noncontingent liquidated secured debts of less than $350,000. *Id.*

190. 11 U.S.C. § 1129(a)(8) (Supp. IV 1980).

191. 6 COLLIER ON BANKRUPTCY ¶ 9.10, at 1595 (J. Moore 14th ed. 1978).

192. *In re* Martin's Point Ltd., 12 Bankr. 721 (Bankr. N.D. Ga. 1981).

193. *See, e.g., In re* Los Angeles Land & Invs., Ltd., 282 F. Supp. 454 (D. Hawaii 1968), *aff'd*, 447 F.2d 1366 (9th Cir. 1971).

rately for administrative convenience;[194] more importantly, similar claims may be classified separately if separate treatment will be afforded under the plan.[195] The only express requirement under the Code is that similar claims classified in the same class receive the same treatment under the plan.[196]

Principle 3: Claims of a similar nature that are classified differently may be treated differently, within reason.

As the case law and common sense demonstrate, the primary reason for separate classification of claims is the debtor's or the creditor's desire to treat certain claims differently from other, even similar, claims. This reasoning also has been applied conversely to require separate classification of claims that will be treated differently under a plan.[197]

The power to classify and treat similar claims in different fashions is not unlimited. Discrimination must be based upon some factual distinctions between the classes of claims, and the treatment afforded the separate classes must be reasonable under the circumstances of the case. These limits are derived from the chapter XI cases that required classification to be "just and reasonably necessary to effectuate the arrangement."[198] The same rule was enunciated by the Fifth Circuit in the *LeBlanc* chapter XII case: "As a general rule, the classification in a plan should not do substantial violence to any claimant's interest. The plan should not arbitrarily classify or discriminate against creditors."[199]

Principle 4: Claims of a similar nature may be classified differently and treated substantially differently when necessary to do equity.

The requirement that a discriminatory classification scheme be just and reasonable still affords the debtor or its creditors great latitude in constructing a plan. The possibilities are almost endless, ranging from separate but equal plans, in which different classes of claims receive different considerations of equal values, to very discriminatory plans, in which one class of claims receives a substantial cash dividend while another class receives nothing. The bankruptcy court sitting as a court in equity will determine whether the separate classification and treatment are just and reasonable or arbitrary and discriminatory.

LeBlanc best illustrates this process. Under the chapter XII plan proposed by the secured creditors in the case, general unsecured claims greater

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194. 11 U.S.C. § 1122(b) (Supp. IV 1980).

195. *See In re* Four Seasons Nursing Centers of Am., Inc., 472 F.2d 747, 749 (10th Cir. 1973); Western Mesa Oil Corp. v. Edlou Co., 143 F.2d 843, 845 (9th Cir.), *cert. denied*, 323 U.S. 786 (1944); *In re* Boston Metropolitan Bldgs., Inc., 92 F. Supp. 843, 848 (D. Mass. 1950); *In re* Burns Bros., 14 F. Supp. 910 (S.D.N.Y. 1936) (division of general unsecured claims into two classes in case under § 77B).

196. 11 U.S.C. § 1123(a)(4) (Supp. IV 1980).

197. Kyser v. MacAdam, 117 F.2d 232, 237 (2d Cir. 1941).

198. Bartle v. Markson Bros., Inc., 314 F.2d 303, 305 (2d Cir. 1963) (citing *In re* Hudson-Ross, Inc., 175 F. Supp. 111, 114 (N.D. Ill. 1959)).

199. *In re* LeBlanc, 622 F.2d 872, 879 n.9 (5th Cir. 1980).

than two hundred dollars were divided into two classes. One class received a forty percent dividend while the other class, composed of claims held by insiders, received no dividend at all. The court rejected an appeal by one of the insiders, relying on the difference between the insiders and the trade creditors who had less knowledge of the status of the debtor's affairs and on the other insiders' consent to the plan. Significantly, the appellant also claimed that the plan operated as an equitable subordination of the insider's claims, in violation of the standards for subordination enunciated in *Benjamin v. Diamond (In re Mobile Steel Co.)*[200] and elsewhere. The Fifth Circuit specifically rejected this claim, holding that the doctrine of equitable subordination did not apply even though the case reached the same result [201]

In re Four Seasons Nursing Centers of America, Inc.[202] also illustrates this principle. The Tenth Circuit upheld a division between shareholders who purchased shares prior to commencement to the chapter X case and shareholders who purchased their shares during the case. It permitted distribution to the former class without any distribution to the latter class, holding that "[t]he reorganization court as a court of equity has broad powers in the matter of classifying creditors and shareholders, and it necessarily has full power to subordinate interests or classes of interests where the equities demand."[203]

Principle 5: The latitude to provide different treatment to claims of a similar nature is limited by the probable result on liquidation.

The latitude to construct a plan, in the absence of facts justifying equitable subordination of a claim or class of claims, is limited not only by justice and reason but also by the probable results of liquidation of the chapter 11 debtor.

This outside limit is approached by two separate paths. The indirect path is suggested by cases such as *LeBlanc* and *Four Seasons*, in which the courts have justified discriminatory treatment of insider creditors and speculator shareholders on the equitable grounds that the classes receiving nothing under the plans would have received nothing in liquidation. Therefore, the unpaid class has not been harmed, even though perhaps more worthy classes of similar claims or interests receive distributions under the plans.[204] The same reasoning was applied in *Palisades*, in which refusal to classify secured claims separately was justified because the objecting creditor would receive almost three times his own valuation of his security if the plan were consummated successfully.[205]

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200. 563 F.2d 692 (5th Cir. 1977).

201. *In re* LeBlanc, 622 F.2d 872, 879 n.9 (5th Cir. 1980).

202. 472 F.2d 747 (10th Cir. 1973).

203. *Id.* at 749.

204. *In re* LeBlanc, 622 F.2d 872, 879 (5th Cir. 1980); *In re* Four Seasons Nursing Centers of Am., Inc., 472 F.2d 747, 750 (10th Cir. 1973); Continental Ins. Co. v. Louisiana Oil Ref. Corp., 89 F.2d 333, 338–39 (5th Cir. 1937).

205. Seidel v. Palisades-on-the-Desplaines (*In re* Palisades-on-the-Desplaines), 89 F.2d 214, 218 (7th Cir. 1937).

The direct path is provided by the "best interest of creditors" test of section 1129(a)(7), which requires either acceptance of the plan by each holder of a claim or interest in the class or a demonstration that each holder of a claim or interest will receive under the plan as much as or more than they would receive in a liquidation under chapter 7 of the Code. Accordingly, a plan of reorganization under chapter 11 cannot be confirmed if the classification and treatment of claims and interests leads a claim or interest holder to receive less under the plan than it would receive in liquidation.

Martin's Point Ltd.[206] illustrates this direct path and at the same time provides a glimpse of the importance of the power to classify. Since the dissenting creditor was a member of a class and was outvoted on plan confirmation, the court was only forced to scrutinize the plan by the best interest of creditors test. Had the dissenting creditor succeeded in being classified separately, the court would have been faced with a dissenting class and could only have confirmed the plan over the objection of the class by the cramdown provision of section 1129(b). This provision incorporates the more onerous requirements of determining whether the plan unfairly discriminates and whether it complies with the long-standing fair and equitable test with respect to each class of claims.[207] This latter test is of particular importance to a chapter 11 debtor since it requires full payment to the dissenting senior class before any value in the debtor can be preserved for junior classes or interests.[208]

VIII. The Emerging Pitfalls and Problems

These emerging principles of classification still leave substantial room for future litigation and classification. In particular, the questions of separate but equal treatment of claims and equitable discrimination between claims are ready for further development.

The question of separate but equal treatment probably will present fewer obstacles to bankruptcy courts. It will arise in more complicated reorganizations, which will present greater opportunities to distribute different forms of consideration, such as notes, stock, or options, of roughly equal value. Although the desirability of some consideration will be greater than others (*e.g.*, cash is better than notes, and notes are better than stock), courts probably will support separate but equal plans if accepted by the separate classes of claim or interest holders. These plans will not violate the principle of equality among creditors, and in addition, the necessity of majority acceptance of the plans will protect against some serious abuses.[209]

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206. *See supra* text accompanying notes 27–33.

207. *See* Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 Am. Bankr. L.J. 133 (1979).

208. *See* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939).

209. 11 U.S.C. § 1129(a)(8) (Supp. IV 1980).

The question of equitable discrimination between claims will be considerably more thorny. On the one hand, the courts will be sympathetic to the consensual reallocation of assets and rights when a majority of affected claim and interest holders have accepted the reorganization plan. This natural inclination to approve settlement agreements will be bolstered by the necessity to demonstrate that all affected parties are receiving as much as or more than they would receive in liquidation. On the other hand, the possibilities for abuses in the classification process, the voting process, and the liquidation analysis are very great, which should lead courts to balance their interest in successful reorganizations with a measure of respect for the principle of equality of treatment for creditors. The unclear reasoning that runs through many of the chapter 13 cases underscores this problem, without suggesting an immediate solution.

Regardless of whatever direction Congress or the courts will provide to courts, debtors, and creditors, the dynamic tension between the principle of equality and the practical politics of reorganizations will not, and cannot, simply go away. Both policies will remain ingrained in reorganization law for years to come.